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## **AGENDA ITEM 6b**

**TO: MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** Financial Market Reform Update
- II. PROGRAM:** Global Equity – Corporate Governance
- III. RECOMMENDATION:** Information
- IV. ANALYSIS:**

This report provides an update on the status of Financial Market Reform and staff priorities for implementation of the Dodd-Frank Act.

### **Executive Summary**

The Dodd-Frank Act outlines a comprehensive framework for reform following the financial crisis. CalPERS was actively engaged during the drafting of the legislation to ensure that critical issues of concern to long-term, responsible investors were addressed. These included oversight of systemic risk, corporate governance, consumer protection, regulatory independence, regulation of the derivatives markets and the credit ratings industry, sustainability and attention to ensure that legitimate investment opportunities were not constrained. A significant number of CalPERS priorities were addressed in the Act.

The proposed reforms are now at the next critical stage - implementation, which will require ongoing engagement by CalPERS. The recent elections have introduced new uncertainty to the process, empowering the legislation's critics to stall implementation through aggressive oversight or through withholding of Congressional funds. Moreover, the complexity of rule-making allows a further opportunity for dilution through lobbying by special interests.

CalPERS is therefore carefully addressing each of its priorities for reform and devoting internal expertise and external advice to ensure its views are properly articulated to the relevant authorities. Given the continuing importance of the

work to the system's objectives, Financial Market Reform has been graduated into the core work program.

### **Background**

CalPERS was significantly affected by the financial crisis. In response, staff developed a statement of Principles for Financial Regulation, which was presented to senior Congressional staff and Commissioners at the Securities and Exchange Commission (SEC) in early 2009. This statement sought to restore confidence in the capital market system by addressing transparency, independence, governance, investment opportunities and systemic risk.

CalPERS then led the agenda for reform through the Investor Working Group, which was convened by the Chartered Financial Analysts Institute and the Council of Institutional Investors (which is chaired by CalPERS Chief Investment Officer, Joe Dear).

These initiatives mapped the critical issues and set out proposals, which were taken up to a significant degree by Congressional proposals. This work provided the framework for CalPERS staff to develop a set of priorities within the complex process of financial market reform.

The Dodd-Frank Act was signed by President Obama in July 2010 at a ceremony attended by CalPERS CIO Joe Dear. However, enactment merely marked the start of the next stage of the policymaking process – rulemaking.

### **Next Steps**

Following careful review, staff identified six priorities for continuing attention during this next stage to implement the legislation. These have been discussed by the Senior Executive Corporate Governance Working Group which provides enterprise-wide oversight on this issue.

The cross asset class team formed to support the legislative phase has been strengthened in order to draw upon internal expertise across CalPERS. Additional advice is provided by external legal counsel, K&L Gates. Advocacy and intervention continue to be led by CalPERS federal representatives, Lussier, Gregor, Vienna and Associates.

CalPERS continues to coordinate its work with fellow public funds and is now reaching out to other major market participants and regulators to discuss in detail the regulations that will give effect to legislative intent.

This is a critical stage of the reform and, arguably, one where CalPERS attention is vital. Staff will continue to monitor issues of concern to CalPERS in the implementation phase of Dodd-Frank, but will be giving particular attention to the following six areas.

### Financial Market Reform: Priorities for Implementation

1. **Corporate Governance:** Dodd-Frank confirmed the SEC's authority to adopt rules which would allow shareowners access to the proxy for nominating candidates for election to the board of directors. The SEC has issued rules, but they are subject to legal challenge. CalPERS is contributing to a court brief which supports the SEC's defense. Staff are preparing their response for new votes on executive compensation ("say on pay") and additional disclosure around board leadership, compensation consultants and votes by institutional investors.
2. **Derivatives:** CalPERS is focusing significant attention on this major area of rule making, which is led jointly by the SEC and CFTC. The aim is to support effective regulation, but ensure detailed provisions do not undermine the main purpose of introducing transparency and clearing to the market. Staff focus to date has been on the definitions of various parties in swaps, proposals for collateral management and establishment of business conduct standards.
3. **Credit Ratings Agencies:** Staff has focused upon the framework for ensuring appropriate disclosure and regulation in this industry, mindful of CalPERS ongoing litigation. A major portion of rule making will be subject to further study by the SEC, which CalPERS supports given the complexity of the issues to be addressed.
4. **Sustainability:** CalPERS continues to pursue opportunities to ensure that environmental, social and governance disclosures are included in corporate reporting in order to assist investors in assessing risks and drivers of value creation.
5. **Systemic Risk:** CalPERS supported the formation of a co-ordination regulatory framework for oversight of risk in the financial markets, and will be continuing to support the call for appropriate levels of funding to ensure enforcement of new provisions by various regulators, especially the SEC.
6. **CalPERS Impact:** Staff are paying particular attention to provisions in Dodd-Frank which may affect the enterprise, such as registration of municipal advisers or non-bank systemically important institutions.

**V. STRATEGIC PLAN:**

This item will further the following goals of CalPERS Strategic Plan:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.
- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

**VI. RESULTS/COSTS:**

Costs are included in existing budget.

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